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Editorial Comment

The Income Tax Act

We now have before us the suggested Income Tax Act to be considered and dealt with at the next session of Parliament as a successor to The Income War Tax Act 1917 as amended on numerous occasions. It is to be hoped that all our readers will study the new proposals carefully and in due course communicate their views to their respective Provincial Institute Legislation Committees.

To this writer, who has not yet made any extensive critical analysis of the proposals, the most interesting clause is Section 4, which is reproduced here in full:—

> "Subject to the other provisions of this Part, income for a taxation year from a business or property shall be determined in accordance with generally accepted accounting principles."

This is a step in the right direction and we must realize fully the responsibility placed on all to become familiar with and to insist upon following generally accepted accounting principles. There is much to be learned in this field by ourselves and by the officers of the Income Tax Department.

A point to be considered is to what extent have our current thoughts on these principles been influenced by previous rulings of the Department and by legal decisions based on the wording of the old Act. There is no doubt that the accounting treatment given to certain transactions has been determined by these considerations. For example, the view of government on the rate of depreciation to be applied to certain assets is not necessarily a fair rate having in mind the conditions under which the assets are used and there is no reason why such rate of depreciation as may be thought by management to be appropriate should not be used in its compution of income. However, passing to Section 12, one finds the following wording:—

"In computing income, no deduction shall be made in respect of . . . "

This raises at once a qualification in the original definition of the word "income" and suggests that, in any section in which such a qualification appears, the words "income subject to tax" should be used. One cannot compute income according to generally accepted accounting principles qualified by Act of Parliament and still refer to it as income. For example, the first qualification in Section 12 is:—

"an outlay or expense to the extent that it was not made or incurred in gaining or producing income from property or a business".

Can anyone say that repairs to a vacant factory building are not to be treated as a deduction in computing income in accordance with generally accepted accounting practice?

A further clear example of the same sort of difficulty is found in Section 10(1)(a).

'There shall not be included in computing the income of a taxpayer for a taxation year (a) an amount that is declared to be exempt from income tax by any other legislation of the Parliament of Canada".

Study of the proposals will be found to be most interesting and an exercise in mental acrobatics of a very vigorous nature. In the meantime, we include herein an article "When Are Expenses Chargeable?" by N. R. Moran, C.A., submitted before the tabling of the proposed Income Tax Act.

Publication Dates

Those contributing items for publication in this magazine, i.e., personal notes, provincial news etc., occasionally complain of the delay involved between the time of submission and the time the magazine reaches them. At the present time, the material is handed to our printers about the 15th of each month and the magazine is mailed some three or four weeks later. Occasionally items received by the 20th of a month can be included, but this is exceptional. All concerned should be governed accordingly.

Accountants Smartest Group U.S. Army Tests Indicate

New York, Aug. 14 (A.P.)

United States army tests given to inductees indicate accountants may be the smartest occupational group, a survey showed recently.

Accountants, on the average, made the highest rating in the tests, lumberjacks the lowest.

The study is reported by Dr. Naomi Stewart in the October issue of "Occupations," journal of the National Vocational Guidance Association. It is based on scores of 80,553 white men, who had worked in 227 different civilian occupations, in their army general classification tests.

The second highest rating was made by mechanical engineering students, followed in order by medical students, chemists, electrical engineering students, writers, civil engineering students, chemical engineering students, teachers and lawyers.

Besides lumberjacks, occupational groups of lowest rank, in order, include: farm workers, miners, teamsters, railway section hands, telephone, telegraph or power groundmen, jackhammer operators, shoe repairmen, barbers, laborers, laundry machine operators, marine firemen, well drillers, longshoremen and forging press operators.

When are Expenses Chargeable?

By N. R. Moran, C.A.

Penticton, B.C.

THERE seems to be a fundamental difference between the accounting and the Income War Tax Act points of view as to when expenses are chargeable. Since it concerns every taxpayer, person or corporation, who derives his livelihood from carrying on business, it is something more than an academic question.

The accounting point of view is that expenses should be allocated to the revenue which they are designed to produce.

The Income War Tax Act point of view is that expenses should be charged in the year that they are incurred, or, in some cases as I shall show later, in the year in which they are paid.

To state the accounting point of view more fully I quote from Paton's Accountants' Handbook:

"Having determined the periodic amount of gross revenue in a particular case it is the task of the accountant to assign thereto the expenses or deductions necessary to a proper determination of net; and the ideal toward which he should strive in this connection is that of determining the charges which are properly deductible in the sense of being logically and economically connected with the volume of revenue under consideration. It is not sufficient that money be expended or liability incurred; it is not even sufficient that items of labor and material have been utilized in the current period; it is necessary to measure the amount of costs incurred and utilized in production which have become embodied in the sales of finished product (assuming that gross is based on sales) for the current period . . . In too many businesses 'expenditure' still seems to be viewed as synonymous with 'expense' (in the sense of revenue charge)."

To state the Income War Tax Act point of view I quote from Consolidated Textiles Ltd. vs. The Minister of National Revenue:

"But it is not necessary to settle the question of the soundness of the appellant's accounting practice, for effect

cannot be given to it for income tax purposes, no matter how sound it might be, if the Income War Tax Act provides, as I think it does, a different basis for the computation of income tax liability. Indeed, the very definition of taxable income in section 3 as 'the annual net profit or gain or gratuity . . . directly or indirectly received' is against the appellant's contention . . . And when the section speaks of the annual net profit or gain or gratuity received I think it must mean that the net is to be determined by deducting from the gross income received in or during the year the deductible disbursements laid out or expended in or during the same year. The taxable income of the year is the difference between the incoming receipts and the outgoing deductible expenditure of that year.

"Moreover, there is a fallacy inherent in the appellant's contention that because the 1938 expenses were laid out or expended for the purpose of earning the 1939 income they are deductible from it. It is not a condition of the deductibility of a disbursement or expense that it should result in any particular income or that any income should be traceable to it."

Now here are two totally irreconcilable concepts of income, although note that over the total life of any business each will produce the same total income figure. There are other differences between the accounting and the Income War Tax Act concepts of income that will not even do that. I refer to expenditures to protect assets or franchise rights or to alter capital structure which the Courts have consistently ruled to be not deductible either in the year expended or spread over future years. These differences we are not concerned with here, although they too are more than an academic question.

Let us examine each of these concepts in turn.

The accountant is concerned with two income problems,

How much income has been earned? (earned in the sense of accrued)

How was the income earned?

He therefore attempts to ascertain the income attributable to each operation or series of like operations. He is not concerned so much with time as with matching up related items of income and expense.

This also seems sound from the point of view of the economist. When expenditures are made in anticipation of

future revenue the "real income" of the payor is not for the moment affected, these expenditures are in the nature of a capital investment with the revenue therefrom being made up partly of a payment for "saving and waiting." When the opposite takes place, and revenues are received in advance of services rendered or goods delivered the "real income" of the recipient is not increased thereby, he cannot command goods and services in trade for these monies since he is not committed to use them to supply the goods which he has obligated himself to supply. Here is one angle at least from which the accounting and economic concepts of income agree.

The application of the Income War Tax Act concept carried to its logical conclusion would ignore all deferred items, both deferred charges and deferred credits. (Strangely enough, from sheer logic, it would not ignore accrued items since accruals are based on time.)

However, on reading another Court decision, that of Thomas D. Trapp vs. The Minister of National Revenue, apparently the Court interprets the Act to mean that accruals should also be ignored. I quote:

"A taxpayer is not entitled, as a matter of right, under the Income War Tax Act as it stands, to elect whether he shall file his income tax returns on an accrual rather than on a cash basis and be assessed for income tax accordingly. It is, in my opinion, clear that section 5(b) allows the deduction of interest on borrowed capital used in the business to earn the income only when the interest has been paid, and that no deduction is allowed in respect of unpaid interest, even although it has become payable or is accruing from day to day."

I think I need not labor the point as to the unsoundness of the Income War Tax Act concept as exemplified by these two decisions. To ignore deferred credits to revenue is to anticipate profit. To ignore deferred charges to expense results not only in distorting operating results, but when the reasoning is rigorously applied, results also in denying such a thing as depreciation.

From the economist's point of view the Income War Tax Act concept is unsound for the very same reason as before, the "real income" is not affected by these receipts or disbursements.

A Suggestion

Since the application of either concept will give the same result in toto, and since the accounting method of determining net income certainly produces a result more useful to business management and the commercial world in general, can we not adopt the Court's own words and say,

"But it is not necessary to settle the question of the soundness of the legal method."

Let us simply change the definition of (taxable) "income" to read,

"The annual net gain or profit or gratuity as determined by customary accounting methods."

Income is not easily capable of being exactly defined and this sort of a definition would force the Court to examine each case on its own particular merits rather than bind it to follow the exact words of the Act. As a matter of fact in the Trapp case the Court volunteered this opinion:

"Income tax law in Canada in this respect lags for behind that of the United Kingdom and the United States and runs counter to well recognized principles of sound business and accountancy practice."

He then proceeded to suggest:

"That the Act be amended with a view to coming nearer the objective of taxing what is truly net profit or gain than the Act as it stands now does . . ."

Fiscal Policy of Corporation Management 1946

By J. D. Campbell, C.A.
Edmonton, Alberta

As we pass from a war time economy with its rather strict regimentation of resources to meet a common cause into a peacetime economy we expect, naturally, to find corporation management following certain definite and well defined policies which in certain instances will differ radically from those adopted throughout the war years. The year 1946 represents the period of readjustment in which the civilian reservoir market is opened shortly after the governmental market has been cut off. The majority of the published reports of the companies examined indicated at their year end a substantial backlog of orders still to be filled although numerous concerns pointed out the problem of supply of both personnel and materials which existed. In certain instances the companies indicated that they had cleared away the backlog of orders arising from the war years, had passed through the period of readjustment and were settling down to a more or less normal anticipated demand.

With a view to ascertaining the nature of the management policies followed in this readjustment period of 1946 an examination was made of the published financial reports of some one hundred and fifty-two companies having their year ends in 1946 ranging from January to December (82 with year ends in December). Comparisons were made with the prior year financial position in each case and statements indicating sources and applications of working capital were prepared for each company. It is from these detailed statements that an attempt was made to draw certain wide deductions as to the possible fiscal policies followed by Canadian corporation management in the fiscal years ending in 1946.

As has been stated by Dr. W. A. Paton in discussing statement presentation, costs rank equally, so it might be stated that funds do likewise although it is true that certain funds do bear a close relationship to certain applications—profits with dividends—depreciation with fixed asset

expenditures—security issues with redemptions. To examine a series of sources of funds and numerous applications it is difficult to reduce them to a workable size both as to content and number unless some offsetting, arbitrary or otherwise, is carried out. Accordingly the terms 'Retained earnings' represents the excess of reported profits over dividends paid—'Unexpended depreciation' represents the excess of depreciation over the expenditure made on fixed assets by the corporation—'Net issues' represents the excess of issues over redemptions. In addition a certain priority is given as to the application or source of funds namely in the order of retained earnings, unexpended depreciation, working capital and net issues (Funded indebtedness, Preferred shares and Common shares in the order mentioned). An alternative order might well have been chosen. In the interpretation of the data presented on the subsequent tables the above assumptions should be kept in mind.

The study proper has been segregated into four main subdivisions, namely:

I Fixed asset expenditures
II Working Capital
III Security Issues and Redemptions
IV General

Fixed Asset Expenditures

As a background for the consideration of the data covering the expenditures made by the corporations on fixed assets and the sources of the funds utilized for this purpose it might be advisable to note that a large number of the concerns involved (1) had in the previous war years embarked on extensive expansion to meet the all out war effort which was being required of them; which equipment in some cases could and in other cases could not be diverted to the use in the production of civilian goods; (2) had to some degree up to this time retarded replacement of equipment to aid the war effort; (3) were faced with a backlog of civilian demand for their products which made expansion of existing facilities probable if the supply situation rendered it possible. To the above might be added the tax relief in the way of double depreciation rates on approved fixed asset expenditures which was promulgated to ease the

burden of this type of readjustment made necessary by the cessation of hostilities.

It was impossible from the available data to break the expenditures made into the various categories indicated. The following table presents the summary of the data collected covering this particular aspect.

Table I

Means Utilized by Canadian Corporations in Financing Fixed Asset Expenditures (1946) (In millions of dollars) (152 companies)

	*A1 (27 companies)	*B2 (82 companies)	*C3 (9 companies)	*D4 (32 companies)	**E5 (52 companies)	Total (152 companies)	
Fixed Asset expenditure ...	$ 23	$ 74	$ 5	$ 70	$ 15	$187	100%
Means of Financing							
Depreciation	11	29	3	25	15	83	44.5
Retained earnings	12	31	—	11	—	54	28.8
Issues of securities	—	—	—	27	—	27	14.4
Decrease in working capital	—	14	2	7	—	23	12.3
	23	74	5	70	15	187	100%

*Indicates different groups as to companies involved based on means of financing where unexpended depreciation did not exist.

**Companies where unexpended depreciation did exist.

A[1] companies: Anglin-Norcross Corporation Ltd., Biltmore Hats Limited, Brandram-Henderson Ltd., Bright, T. G. & Co. Ltd., Caldwell Linen Mills Ltd., Calgary Power Ltd., Canada Iron Foundries Ltd., Canadian Vickers Limited, Consolidated Mining & Smelting Co. of Canada Ltd., Fraser Companies Ltd., Imperial Varnish and Color Co. Ltd., International Metal Industries Ltd., Levy Brothers Co. Ltd., Maple Leaf Milling Co. Ltd., Mercury Mills Ltd., National Breweries Ltd., Molson's Brewery Ltd., Powell River Co. Ltd., Quebec Power Company, Sicks' Breweries Ltd., Silknit Limited, Simon H. & Sons Ltd., Simpson's Limited, Slater, N., Co. Ltd., Standard Clay Products Ltd., United Steel Corp. Ltd., Wilsil Limited.

B[2] companies: Aluminium Limited, Bathurst Power & Paper Co. Ltd., Belding Corticelli Limited, Brantford Roof-

ing Co. Ltd., Building Products Ltd., Canada Vinegars Ltd., Canadian Bakeries Ltd., Canadian Car & Foundry Co. Ltd., Canadian Western Natural Gas, Light, Heat & Power Co. Ltd., Cosmos Imperial Mills Ltd., Crown Cork & Seal Co. Ltd., Disher Steel Construction Co. Ltd., Dominion Engineering Works Ltd., Evans Coleman & Gilley Bros. Ltd., Goodyear Tire & Rubber Co. of Canada Limited, Greening, B., Wire Co. Ltd., Hayes Steel Products Ltd., Hiram Walker-Gooderham & Worts Ltd., Imperial Oil Limited, International Petroleum Co. Ltd., Kelvinator of Canada Ltd., Labatt, John, Limited, Laprairie Company Inc., Melchers Distilleries Limited, National Grocers Co. Ltd., Ogilvie Flour Mills Co. Ltd., Page-Hersey Tubes Limited, Riverside Silk Mills Ltd., Russell Industries Ltd., Southern Canada Power Co. Ltd., Tuckett Tobacco Co. Ltd., Willson Stationers and Envelopes Ltd.

C[3] companies: Amalgamated Electric Corporation Ltd., Canada & Dominion Sugar Co. Limited, Canadian Marconi Co., Consumers Gas Co. of Toronto, Dominion Woollens & Worsteds Ltd., Fairchild Aircraft Ltd., Ford Motor Co. of Canada Ltd., Mitchell, The Robert, Co. Ltd., West Canadian Hydro Electric Corp.

D[4] companies: Atlas Steels Ltd., Bell Telephone Co. of Canada, Brewers and Distillers of Vancouver Ltd., British Columbia Telephone Co., Canada Wire & Cable Co. Ltd., Canadian Breweries Ltd., Canadian Converters' Co. Ltd., Canadian Dredge & Dock Co. Ltd., Canadian Food Products Ltd., Canadian Oil Companies Ltd., Canadian Utilities Ltd., Canadian Westinghouse Co. Ltd., Cockshutt Plow Co. Ltd., Consolidated Bakeries of Canada Ltd., Dominion Bridge Co. Ltd., Dominion Malting Co. Ltd., Dominion Stores Ltd., Dominion Tar & Chemical Co. Ltd., Foundation Co. of Canada Ltd., Inglis, John, Co. Ltd., La Compagnie Legare Limité, Lower St. Lawrence Power Co., Massey-Harris Co. Ltd., Maritime Telegraph and Telephone Company Ltd., New Brunswick Telephone Co. Ltd., Niagara Wire Weaving Co. Ltd., Quebec Telephone & Power Corporation, Shawinigan Water & Power Co., Silverwood Dairies Ltd., Standard Chemical Co. Ltd., Western Breweries Ltd., Zeller's Limited.

E[5] companies: Algoma Steel Corporation Ltd., Blue Ribbon Corporation Ltd., British American Bank Note Co. Ltd., Canada Cement Co. Ltd., Canada Northern Power

Corp. Ltd., Canada Packers Ltd., Canadian Canners Ltd., Canadian Light & Power Co., Canadian Locomotive Co. Ltd., Canadian Wallpaper Manufacturers Ltd., Catelli Food Products Ltd., Chateau-Gai Wines Ltd., Claude Neon General Advertising Ltd., Consolidated Paper Corporation Ltd., Cooksville Co. Ltd., Crescent Creamery Co. Ltd., David & Frère Ltée., Dominion Dairies Ltd., Dominion Textile Co. Ltd., Federal Grain Ltd., Gatineau Power Co., Great West Saddlery Co. Ltd., Gurney Foundry Co. Ltd., Holt Renfrew & Co. Ltd., Imperial Tobacco Co. of Canada Ltd., International Nickel Co. of Canada Ltd., Lake St. John Power & Paper Co. Ltd., Langley's Ltd., Lindsay C. W. & Co. Ltd., Marcus Loew's Theatres Ltd., Lowney, Walter M., Co. Ltd., MacKinnon Structural Steel Co. Ltd., Montreal Cottons Ltd., Montreal Refrigerating & Storage Ltd., Orange Crush Ltd., Penmans Ltd., Photo Engravers & Electrotypers Ltd., Price Brothers & Co. Ltd., Quebec Railway Light & Power Co., Reliance Grain Co. Ltd., Robin Jones & Whitman Ltd., Rolland Paper Co. Ltd., Sawyer-Massey Ltd., Southam Co. Ltd., Standard Fuels Ltd., Thrift Stores Ltd., Tooke Bros. Ltd., Union Gas Co. of Canada Ltd., United Amusement Corp Ltd., United Grain Growers Ltd., Western Grain Co. Ltd., West Kootenay Power & Light Co.

It is interesting to note that funds to the extent of approximately 86% of the required amounts were obtained internally from those sources over which management has direct control whereas only 14% were obtained externally through the issue of securities.

The utilization of working capital represents a liquidation of resources apparently accumulated during the war years for this purpose but which were held dormant as cash funds or government securities. This is indicated by the fact that the decline in working capital in most cases where working capital was drawn upon showed the distinct pattern as mentioned above.

Based on the assumption that the depreciation provisions made during the fiscal year by the various companies represented a normal provision, the facts accumulated on the one hundred and fifty-two companies did indicate an expansion program with one hundred companies making expenditures on fixed assets in excess of the provisions

made in their books for depreciation. No distinct industry pattern was discernible in the companies examined which would lead one to believe that the expansion was confined to definite industries.

Tables II and III present the accumulated condensed source and application of funds statements for the one hundred companies showing an excess of fixed asset expenditures over the depreciation provisions as well as the summary of the detailed changes in the various items making up the working capital change.

Table II

Source and Application of Working Capital for 100 Canadian Corporations having an excess of fixed asset expenditures over their depreciation provisions in 1946
($ 000 omitted)

Net profit after provision for depreciation		$146,048	
Less Dividends paid—Common	$82,146		
Preferred	5,937	88,083	57,965
Issue of funded indebtedness		122,314	
Less redemptions of funded indebtedness		106,117	16,197
Issue of common share capital			48,591
Decrease in working capital			20,071
Miscellaneous			2,232
			$145,056
Redemptions preferred shares	$41,578		
Less: Issues preferred shares	6,022	$ 35,556	
Investment in subsidiaries		4,689	40,245
Fixed asset expenditures		$171,885	
Less depreciation provisions		67,074	$104,811

Table III

Changes in Working Capital for 100 Canadian Corporations having excess of fixed asset expenditures over the depreciation provision in 1946
($ 000's omitted)

Cash	— 27,372
Accounts and bills receivable	17,594
Inventories	72,724
Investments	— 47,296
Deferred charges	3,644
Bank loans	— 14,537
Accounts payable	— 18,994
Reserve for taxes	— 3,011
Miscellaneous accruals	— 2,823
Net decrease	—$20,071

The analysis made under Table I represents an individual analysis of each company whereas the information presented on Table II represents a summarization of the individual source and application of funds statements by amounts only.

An examination of Table III indicates that although there is a net decrease in working capital, expansion of certain sections of the working capital (accounts and Bills receivable, inventories and deferred charges) did take place in line with the increased productive long term capacity disclosed by Table II.

A comment has already been made on the decrease in cash and investments. Some significance might be placed on the expansion of short term credit which has taken place in the form of bank loans, accounts payable and reserve for taxes. Other things being equal the change in the reserve for taxes might be indicative of sustained and increased earnings over those of the prior year for the companies included.

Tables IV and V present the accumulated condensed source and application of funds statements for the fifty-two companies which show unexpended depreciation as well as the summary of the detailed changes in the various items making up the working capital change.

Table IV

Source and Application of Working Capital for 52 Canadian Corporations having unexpended depreciation during 1946
($ 000's omitted)

Redemption of funded indebtedness			$158,797	
Less Issues of funded indebtedness			143,794	$15,003
Redemption of preferred shares			4,987	
Less Issues of preferred shares			3,399	1,588
Increase in working capital				18,969
Investment in subsidiaries				6,914
				$42,474
Financed by:				
Issue of common shares			$ 3,788	
Net profit before depreciation		$65,759		
Less: dividends common	41,222			
preferred	6,263	47,485		
			18,274	
Miscellaneous			8,318	$30,380
Depreciation provided			$ 27,250	
Less: Fixed asset expenditures			15,156	$12,094

Table V

Changes in Working Capital for 52 Canadian Corporations having unexpended depreciation in 1946.

($ 000's omitted)

Cash	$ 2,897
Accounts and bills receivable	585
Inventories	—7,898
Investments	6,547
Deferred charges	18
Bank loans	14,455
Accounts payable	347
Reserve for taxes	1,347
Miscellaneous accruals	671
	$18,969

An examination of tables IV and V indicates a somewhat different pattern from that presented on Tables II and III with net redemptions of funded indebtedness replacing net issues, a net increase of working capital in place of a net decrease and unexpended depreciation in place of over-expended depreciation. Taken together it does not appear unreasonable to state that the companies represented in Tables IV and V are utilizing the resources which are made available to them in putting their houses in order financially. The degree to which the depression of the 1920's has an indirect bearing on the policies followed by the management of these companies after this second world war might be interesting.

The analysis of the working capital for the companies having unexpended depreciation is interesting, reflecting the same conservative policy directed towards improving their financial position. The decrease in inventories offset by an increase in cash and investments as well as the decrease in bank loans and accounts payable points in this direction.

Working Capital

The analysis of the changes in working capital for the individual companies indicated that of the one hundred and fifty-two corporations, 79 showed an increase in working capital and 73 showed a decrease in working capital. Although certain comments have already been made in respect to working capital in as much as it has a bearing on the over and under expended depreciation, the following analyses presented on Tables VI and VII might be of interest. You are referred to the assumptions which have

been made as to priority of items in the preparation of the data.

Table VI

Decreases in Working Capital in 73 Canadian Corporations in 1946 and the manner in which it was utilized.
(in millions)

Expansion of fixed assets		$23	36 %
Losses suffered and payment of dividends in excess of earnings and unexpended depreciation		5	7.8%
Redemptions of securities			
Funded indebtedness	13		
Preferred shares	14		
	—	27	42.1%
Miscellaneous		9	14.1%
		$64	100.0%

Forty-seven corporations fell in the category of expansion of fixed assets of which 37 covered the expansion cost by decreases in cash and investments within the working capital.

Table VII

Increases in Working Capital in 79 Canadian Corporations in 1946 and the sources from which it arose.
(in millions)

Retained earnings		$22	35.0%
Issue of securities			
Funded indebtedness	12		
Preferred shares	1		
Common shares	10		
	—	23	36.5%
Unexpended depreciation		7	11.1%
Miscellaneous		11	17.4%
		$63	100.0%

The use of funded indebtedness for the purpose of increasing working capital might be noted. This may be a reflection (1) of the low interest rates which prevail at present although it might be closely correlated to the redemption procedures which in the majority of cases were carried out when the new issues were being made; (2) of the reduced drain in the security markets by the Dominion government.

In the case of the common share issues the former was not the case as the issues were made with the view in mind of increasing the working capital.

Security Issues and Redemptions

The results of the analysis made of the individual companies involved in respect to security issues and redemptions disclosed in the case of funded indebtedness and preferred share capital, a policy of strengthening the position of the common shareholders in the capital structure either by a refunding procedure resulting in lower net fixed charges or a net reduction of this type of capital either through the medium of retained earnings or the issue of junior securities. The majority of the changes which took place fell within the first category.

Funded Debt

Tables VIII and IX cover the items of Funded debt and have been drafted to indicate (within the limits of the assumption made in their preparation) the utilization made in the case of the issues and the sources from which the funds were drawn in the case of the redemptions.

Table VIII

Utilization of Funds Received from the Funded Debt Issues made by 39 Canadian Corporations in 1946.
(in millions)

Redemptions			
Funded debt	237.2		
Preferred shares	3.6		
		$240.8	90.3%
Increase working capital		12.3	4.7
Fixed asset financing		7.9	3.0
Miscellaneous		5.1	2.0
		$266.1	100.0%

Table IX

Method of Financing the Redemption of Funded Debt carried out by 66 Canadian Corporations in 1946.
(in millions)

Issues of securities			
Funded debt	237.2		
Preferred shares	.4		
Common shares	2.1		
		$239.7	90.5%
Retained earnings		8.5	3.2
Unexpended depreciation		5.3	2.0
Decrease in working capital		11.4	4.3
		$264.9	100.0%

There is no means of telling whether or not the tax situation in 1946 had any bearing on the preferred share capital picture as to the replacement of preferred shares by funded debt. The priority assigned in building up the tables would serve to minimize rather than maximize this difference.

Preferred Share Capital

Tables X and XI cover the items of Preferred share capital indicating the data comparable to that presented under Funded Debt.

Table X

Utilization of Funds received from Preferred Share issues made by 6 Canadian Corporations in 1946.
(in millions)

Redemptions			
Funded debt	$ .4		
Preferred shares	7.6		
		$ 8.0	85 %
Increase in working capital		.6	6.5%
Fixed asset financing		.8	8.5%
		$ 9.4	100.0%

Table XI

Method of Financing the Redemption of Preferred Share Capital carried out by 22 Canadian Corporations in 1946.
(in millions)

Issues of securities			
Funded debt	$ 3.6		
Preferred shares	7.6		
Common shares	11.9		
		$23.1	49.5%
Retained earnings		6.1	13.2
Unexpended depreciation		.7	1.5
Decrease in working capital		14.0	30.0
Miscellaneous		2.7	5.8
		$46.6	100.0%

The above tables reflect clearly the continued policy on the part of management of cleaning house particularly in those instances where the corporation had preferred share capital with substantial arrears of cumulative dividends attached to them. The above tables do not reflect only fund transactions but have included in some instances exchanges of securities arising from reorganization. This applies particularly where the information was not given to enable the segregation to be made.

The substantial reduction in working capital appears to substantiate the general overall policy mentioned in respect to preferred share redemptions with an aim towards a consolidation and strengthening of the position of the common shareholder.

Common Share Capital

Table XII covers the item of Common share capital indicating the data in respect to issues comparable to that presented under Funded debt and Preferred share capital.

Table XII

Utilization of Funds received from Common Share issues made by 25 Canadian Corporations in 1946.
(in millions)

Redemptions			
Funded indebtedness	$ 2.1		
Preferred shares	11.9		
		$14.0	26.8%
Increase in working capital		10.1	19.3
Fixed asset financing		18.4	35.0
Investment in subsidiaries		5.7	10.9
Miscellaneous		4.2	8.0
		$52.4	100.0%

The above table presents an interesting aspect namely in respect to the use of common share capital as a means of expansion in the field of fixed assets and the correlated item of working capital. Approximately eighty percent of the amounts involved in these two items occurred in respect to an issue made by the Bell Telephone Company of Canada.

General

No attempt has been made in the above study to present trends which are so significant particularly in respect to the use of the data collected for economic analysis. In this respect it carries its major deficiency. Although this fact is recognized it does serve to verify certain features of the readjustment period in respect to corporation management.

It may be of some interest at this point to present the combined statement of source and application of working capital and analysis of changes in working capital for the aggregate of the corporations included. This information is presented on Tables XIII and XIV.

Table XIII

Source and Application of Working Capital for 152 Canadian Corporations with their fiscal years ending in 1946.

(in millions)

Retained earnings			
Net profit after provision for depreciation		$211.9	
Less: Dividends—Common	123.2		
Preferred	12.2	135.4	
			$ 76.5
Net Issues			
Funded debt issue	266.1		
Funded debt redemptions	264.9		
		1.2	
Common share issue		52.3	
			53.5
Miscellaneous			10.3
			140.3
Less			
Net redemptions			
Preferred share redemptions	46.6		
Less Preferred share issues	9.4		
		37.2	
Overexpended depreciation			
Fixed asset expenditures	187.0		
Less depreciation provision	94.4		
		92.6	
Investment in subsidiaries		11.6	141.4
Net decrease in working capital			$ 1.1

Table XIV

Changes in Working Capital for 152 Canadian Corporations with their fiscal years ending in 1946.

(in millions)

Cash	$—24.5
Accounts and bills receivable	18.2
Inventories	64.8
Investments	—40.7
Deferred charges	3.7
Bank loans	nil
Accounts payable	—18.6
Reserve for taxes	— 1.8
Miscellaneous accruals	— 2.2
	$— 1.1

The combined picture of the corporations examined presented under Tables XIII and XIV discloses certain features which raise pertinent questions applicable both as to the group of corporations examined as well as to the broader aspect of the industrial field.

It is interesting to note that the level of retained earn-

ings was similar to the level established in a similar study made for 1940 in respect to 118 Canadian Corporations which was published in the January 1942 issue of The Canadian Chartered Accountant. This stood at 46% of the net profits after provision for depreciation. Whether this represents the action of entirely different factors, namely in 1940, a desire to further the war effort and, in 1946, a policy of internal financing which would not load the companies with fixed charges which might later prove embarrassing is a matter of question as against a general overall management policy leaning towards the latter.

The relationship of depreciation to the expenditures made on fixed assets as between the two studies shows a relatively wide divergence ranging from 83% in 1940 to 50% in 1946. The extent to which concerns had unproductive fixed assets in 1940 might have a distinct bearing on this picture which is in part substantiated by the increase in working capital disclosed in that year which amounted to an increase of 58% of the expenditures made in that year on fixed assets.

Although the negligible decline in working capital in 1946 does not appear to coincide with the substantial increase in working capital, an examination of the detailed changes set out on Table XIV indicates a substantial increase in the working portions of the current assets, accounts and bills receivable and inventories. The reduction in cash and investments as previously stated indicates the management policy resulting from the raising of the restrictions imposed on industry throughout the war years.

The relatively small amounts involved in respect to net issues of funded indebtedness (Table XIII) and the flat position in respect to Bank loans (Table XIV) in 1946 raises certain questions from the broader economic aspect as to the use of these particular types of financing by Canadian industry. Within the group, attention should be called again to the deductions which have been drawn covering the reflections as applied to specific groups.

Although the sample of Canadian corporations which was chosen is by no means all inclusive it does give a fairly representative cross section of the Canadian industrial economy and serves to indicate qualitatively if not quantitatively the general nature of the fiscal policies of Canadian industrial management.

Provincial News

Ontario

The Council of the Ontario Institute is arranging a dance for the Members and their Ladies to be held on Thursday, October 2nd, 1947, at the Royal York Hotel. Full information in connection with this dance will be mailed to the Members in the near future.

The Institute of Chartered Accountants of Ontario has announced the appointment of E. D. Scott as registrar of the Institute. For the past few years Mr. Scott has been engaged in personnel matters at DeHavilland Aircraft of Canada Limited.

Quebec

At the annual meeting of the Institute of Internal Auditors (Montreal Chapter) the following officers and governors were elected: President—R. A. Taylor, Sun Life Assurance Company of Canada. Vice President—K. W. Atkinson, C.A., Dominion Rubber Company Limited. Secretary—J. W. H. Maxwell, Canadian Industrial Alcohol Company Limited. Treasurer—Harold W. Joyner, C.G.A., Standard Brands, Limited. Governors—J. A. Desrochers, C.A., National Breweries, Limited; W. F. Quayle, C.A., Northern Electric Company Limited; G. H. Greening, Bank of Montreal; M. H. Robinson, Royal Bank of Canada; F. A. Cooper, Bruck Silk Mills, Limited; Reg. Uden, Canada Packers, Limited.

A cordial invitation is issued to Chartered Accountants to join the Montreal Chapter or to attend as guests at dinner meetings, which are held in the Windsor Hotel on the fourth Monday of each month from September to May at 6.30 p.m.

The Economic Crisis In Britain

By J. R. Petrie

(Continued from August issue)

The second obstacle to increased British exports is the low productivity of British manufacturing compared with that of its chief competitors in export markets, i.e., the United States and Canada. The Royal Economic Society, in its Memorandum No. 107 (Sept. 1946) states that in 1937 "the Americans succeeded in producing twice as much wealth per head in manufacturing industry as did either Great Britain or Germany." Part of the reason for this is obsolete or worn-out plant, coupled with inefficiency and failure in some industries to adopt new technical improvements. In industries sheltered by tariffs and producing at guaranteed minimum prices through cartel agreements, inefficiency has been perpetuated rather than liquidated, as it would have been under competitive conditions. A second factor, at least in some industries, is undoubtedly the lack of full labour-management co-operation.

Part of the Government's plan provides for the replacement of worn-out and obsolete plant. Foreign exchange has been allocated on a priority basis for importing machinery for essential industries. The overall programme of capitol improvement is distributed 48 per cent to building (20 for housing and 28 for industrial purposes), and 52 per cent for plant. But the more difficult problem of getting more men to work longer and harder is not solved yet, and some elements of the Government's policy seem to be working at cross purposes. Since the output of domestic industries is woefully inadequate, the nation needs an increase in output per man-year, not merely higher production per man-hour offset by longer holidays. But the Government has not taken any stand against the application of the forty hour week urged by the trade unions.

The manpower shortage is critical and output cannot be increased to target levels until more workers are available. Fourteen industries specified in the White Paper need 657,000 additional workers, an increase of 22 per cent over the present total, in order to regain their pre-war labour force. Yet the Government has just raised the

school leaving age, thus removing 370,000 potential workers from the labour market this year. Appeals have been made to older people to stay at work instead of retiring, and to women to enter industry. But it is unlikely that any significant increase in the labour force will come from this direction. Foreign labour, according to the official statement, is the only substantial source of additional manpower.

A policy of importing 500,000 new workers requires union support, and there are signs that such policy is not acceptable without reservations. After what the London Economist called "monstrous higgling," the Government secured the entry of a few thousand Poles for the agricultural and coal industries. One cannot tell why so few were brought in, unless there is a hard core of opposition to the plan. Only recently Mr. Isaacs turned down, with no good reason stated, a proposal to allow Italian ex-prisoners of war to return to farm work in Britain. The difficulty seems to lie in the attitude of British labour. If a Labour Government cannot persuade the trade unions that the importation of foreign workers is the only way to avoid economic collapse, there is little hope indeed.

Rising costs and prices are another factor having important bearing on Britain's export position. While this was not so important last year, when availability of supplies rather than price characterized world markets, competition is now bound to exert its influence as one nation after another begins an export drive to maintain full employment at home. It is unlikely that a recession in the United States can be postponed for more than another year, and if that country makes a determined effort to export her unemployment, there will be sharp competition in the world markets. It is of the greatest importance, therefore, for Britain to be in a competitive position if her export goal is to be realized.

The extent to which British prices are rising is seen in the following figures: the wholesale price index of iron and steel increased by 13 points between June 1945 and June 1946; non-ferrous metals increased by 16 points during the same period, cotton by 12, other textiles by 11. In December of 1946 the general wholesale price index stood at 145.2, compared with 111.8 in Canada and 140.9 in the United States. The price index of British exports rose from 189 in January to 192 in April and 198 in May.

An important cause of the increase in prices and costs has been the increase in wages accompanied by decreased productivity. During the war the cost of producing coal rose to such an extent that in the summer of 1945 American coal was competing profitably with British coal in Britain. High coal prices add to the costs of nearly all other industries through increased power costs. The steel industry which in Britain consumes two tons of coal for each ton of steel manufactured, is particularly affected by coal costs. British steel prices in 1944 were estimated to be about 25 per cent higher than American, and British structural steel is reported to cost nearly 40 per cent more than the Australian product.

By October of 1947 basic wage rates had risen to 64 per cent over the pre-war level. Average earnings of all workers were 89 per cent greater in July, 1946 than in October, 1938. The steady pressure of excess purchasing power on the short supply of goods and services (there are £7 of purchasing power for £6 of available consumer goods and services) is a constant inflationary threat. There was no government wage control during the war, but it is now announced that "while the Government adheres to its long term objective of raising the standard of living, any further general increases in wages and profits must be accompanied by a corresponding increase in production."

Another important factor entering the British cost and price structure is the price situation in the United States and the appreciation of the exchange value of the Canadian dollar. Britain is now buying in expensive and selling in cheap markets. But her only hope of attaining equilibrium is buying in the cheapest market and selling in the dearest. If she is to have a solid base for expansion she cannot afford the luxury of expensive raw materials. Currently she has little choice, with sources of supply so limited. But it will be necessary, as soon as new and cheaper sources become available, to change customers. The implications for Canada and the United States are clear enough.

As long as dollar country food and raw materials are necessary, Britain will need hard currency with which to pay for them. Apart from the dollar credits, there is no other source of funds except through exports to hard currency countries. This is not easy to accomplish. In 1946

the largest suppliers of the United Kingdom were the United States and Canada. About 46 percent of her total imports came from dollar countries. But most of the exports (86 per cent) went to sterling or soft money countries where Britain already has ample credit or sterling exchange.

There are two important problems connected with marketing British goods in Canada and the United States. In the first place, the important British export commodities must compete with similar North American commodities in their home markets. Machinery, vehicles, iron and steel products, chemicals and textiles, the leading British export items, are all produced in America, in many instances at lower costs. In the second place, where British commodities are competitive, they are almost invariably confronted with a tariff barrier designed to protect the domestic industry.

The outlook is serious but by no means hopeless. It is encouraging that the British Government is so aware of the problem in all of its aspects and has decided upon the policy deemed best suited to meet it. One may criticize the overall domestic programme for containing much that is not pertinent to a solution of the problem—perhaps hindering it in some instances by attempting too much too soon. It seems quite obvious that Britain cannot afford now much of the economic luxury promised by the Labour Government. But there is little room for objection to the basic economic programme of control over capital, production, imports, exports and foreign exchange. It looks as if control over manpower were necessary, too, and it seems likely that the wartime power to divert labour into essential industries will have to be reassumed. Britain is fighting for her life now just as much as she was during the war, and against similar odds. Rigid controls and even regimentation are essential to success. It is reported that a new production chief, a sort of economic prime minister, is to be appointed to direct all economic operations during the next two or three years. A new White Paper is now in preparation outlining a four year economic plan.

In view of all this, it would be foolish to write Britain off. She has a great deal of production knowhow, and not all of her capital plant is worn out or obsolete. The war

gave birth to a great deal of modern productive capacity. The coal probelm is soluble, and under nationalization, it seems likely that technical improvements long delayed will be made soon. The miners are likely to be much more co-operative than they were under private ownership. When coal is produced in surplus quantities, the back of the production problem will be cracked, if not broken.

It will take time to solve the problem of low productivity in the manufacturing industry, and in some branches it may not be solved. Many modern and efficient plants are now in operation, and countless others are being constructed. Difficult as the internal industrial problem is, it is not as serious as during the Blitz, when productive capacity was being knocked out daily. Travelling about post-war Britain, one gets the feeling that the industrial problem will be solved more quickly than generally anticipated in America. Furthermore, if British price and wage controls should hold the line while wages, costs and prices continue to rise in North America, we may be priced out of many export markets.

I am reasonably optimistic about Britain's ability to solve her internal problem of production. But the dollar problem is for the most part quite beyond her control. If the dollar countries are not willing to take British goods in large volume, Britain will be forced to withdraw from multilateral trade, entrench herself in a sterling area that will include much of the world market, and embark upon a plan of bilateral trade agreements that will mean virtually a barter system of international trade. The results of such a policy would mean not only economic stagnation in Britain, but a major economic disaster for Canada. In 1945 we sold 47 per cent of our total commodity exports in the Empire, a sterling area. The result of losing this market is apparent. In New Brunswick the lumber industry would suffer seriously, and the Prairie wheat economy would collapse. Just last week Britain announced that she could not take Canadian apples next year because she has insufficient Canadian exchange to pay for them.

Despite commitments against such action, in the event of necessity Britain is certain to go to this extreme, for she will not—cannot—survive under a continuation of present conditions. Speaking during the 1945 general election,

Winston Churchill said that "we cannot give up the right to safeguard our balance of payments by whatever means are necessary," and in this he spoke for all parties. "The Times" sounded an ominous warning in a recent editorial when it said that "means (other than loans) of insuring supplies from abroad by special arrangement with this country's customers may become inescapable." There is no mistaking the implication of these words. If pressed hard enough, Britain could undoubtedly use her position as the world's greatest importer to force her manufactured goods on the markets of foreign suppliers with a great measure of success, thus crippling the North American export trade.

Responsibility now rests primarily on the United States and to a lesser extent upon Canada to assist Britain to obtain dollar exchange through commodity exports. The important question is how far these countries are prepared to go in really lowering tariffs and encouraging the entry of British goods. The United States, with world leadership thrust upon her by the war, can either lead the fight against economic nationalism by example, through abandoning the discriminatory trade practices so long a part of her national policy—subsidized exports, dumping and high protective tariffs—or she can continue them and force Britain, her empire, the near and middle east and most of Europe to revert to mutually ruinous barter arrangements.

It will not be easy to establish the necessary policy in a country already beset by fears of British socialism and worried about the maintenance of full employment at home. Canada, in her traditional role as interpreter for the United States and Britain, can be of immeasurable assistance by example and persuasion. Canada's economic life is as much at stake as Britain's, and in her own self interest her policy should be directed unceasingly towards the freeing of world markets and the elimination of discriminatory trade practices. Unless this goal is achieved soon, the foundations of the world economy will be shaken to the point of collapse.

Comments on Current Practice

By Clem L. King, C.A.
Secretary and Director of Research
The Dominion Association of Chartered Accountants

EDITOR'S NOTE:—From time to time it is our intention to publish notes prepared by Clem L. King, C.A., in his capacity as Director of Research of the Dominion Association of Chartered Accountants, on various matters arousing his interest as he carries on his work. The logical outcome of these duties over a lengthy period will be the issuance of pronouncements by the Accounting and Auditing Research Committee. Before this final stage is reached, however, it would seem useful to throw open Mr. King's thoughts for public review. It is emphasized that these notes are not to be considered as pronouncements or official releases of the Association or of a Committee of the Association. Mr. King hopes that these periodic and, perhaps spasmodic, invitations will be accepted by many readers and that they will put forward their views as informally as he has put forward his. The replies received will not necessarily be published and in any event no reply will be published without preliminary discussion with the writer.

PROFIT AND LOSS CONCEPTS

THE complexities of the modern business world do not stand out more clearly than when one considers the problems that surround the statement of profit and loss.*

Most business ventures are operated on the assumption that they will continue from year to year. It goes without saying that it is anticipated that there will be profits from year to year or, at the very least, the results of the venture over a period of years will provide a reasonable average annual profit.

Because it is necessary to have information periodically as to the success or otherwise of the venture in order to make the necessary adjustments to meet changing economic conditions, and because the Income Tax Act and the Companies' Acts require an accounting for the operations for the year, the annual statement of profit and loss is prepared. In the case of limited companies, these periodic statements are often the only information that the owners (the share-

*The term "statement of profit and loss" is used because a survey of recently published Canadian Statements showed that for every instance in which it was called the "income statement" there were five instances in which it was called the "Profit and loss statement". Practice in the United States has altered more rapidly than in Canada, and in that country the proportions are almost the reverse.

holders) receive as to the success or otherwise of the venture in which they have invested a portion of their private capital. Their interpretation of the information given in these reports determines the ultimate disposition that they will make of their holdings.

Profit and Loss Concepts

As previously mentioned, the statement is prepared on the assumption that the business or venture is a "going concern" and will continue for some time at least. In addition, the statement is ordinarily prepared for presentation to the owners of the enterprise, i.e., its prime purpose is to reflect the change in their equity during the period, and in so doing, management renders an accounting of its stewardship. Up to this point most accountants are in agreement as to the concepts upon which the statement is based.

A fundamental difference of opinion arises between those who choose the "historical" approach and those who choose the "earning power" approach. In the former, the statement is prepared to show the changes in the owners' equity from that as shown on the previous balance sheet, other than those changes arising from dividends or transactions with the owners in respect of their equity. In other words, the profit and loss statements issued during the life of the venture record the increase or decrease in proprietorship equity, except for dividends and transactions in that equity. In the latter approach, the statement is prepared so as to show the profit, or loss, from ordinary business transactions occurring during the period under review. Since, consciously or otherwise, future probabilities are based upon past happenings, statements prepared under this concept are often termed "prospectus type" statements because they are so often used in forecasting probable future earnings.

It might be said with some justification that the "historical" type statement is more useful to the "long term" owner, and the "prospectus" type statement is more useful to the "short term" owner.

Historical Concept

The advocates of the historical approach believe that over a period of years, the profit and loss statements should show all changes in the owners' equity which result from

the conduct of the business. This means of course that they advocate that the statements show the profit or loss on ordinary business operations, extraordinary gains and losses, all adjustments in respect of prior periods, in short, all items except contributions by and distributions to owners. They claim that the items ordinarily classed as extraordinary or non-recurring are to be expected to appear during the conduct of any venture, and merely because they may be unusual does not mean that they do not arise as a result of business operations.

Fundamentally this concept holds that in any business venture, the so-called ordinary and recurring operations are only part of the transactions that are expected to take place in the dealings with the contributed capital in an effort to secure a profit. At the start of a venture, cash is contributed; this cash is then used to purchase buildings, equipment, supplies, inventories and to meet the expenses incurred in getting operations started. During the life of the venture, the inventories are turned over periodically, and in addition, there are usually certain changes and replacements in respect of the fixed assets, investments etc. The dealings in the inventory, or the ordinary and recurring operations of the business, produce profits which may be augmented or reduced by the results of other business transactions. So far as the owners are concerned, it is the aggregate of the "ordinary" profits and losses and the "extraordinary" gains and losses which indicates whether or not they have made an investment which yields a reasonable return.

The Accounting Research Committee of the American Institute of Accountants favors this concept, as will be seen from the following excerpt from their Bulletin No. 8:

> "Over the years it is plainly desirable that all costs, expenses, and losses of a business, other than those arising directly from its capital stock transaction, be charged against income. If this principle could in practice be carried out perfectly, there would be no charges against earned surplus, except for distributions and appropriations of final net income."

W. A. Paton has the following to say in his book "Advanced Accounting":

> "The income sheet (or 'income statement', 'profit and loss statement', or 'loss and gain account', as it is variously labeled) may be defined as any systematic statement or report which exhibits the

amount of the periodic net income of the business enterprise and which shows, either in summary or in detail, the origin of such income and its appointment or assignment to the various equities involved. In its most comprehensive and satisfactory form it also includes all direct surplus adjustments and the final amount of unappropriated surplus as displayed in the accompanying balance sheet. The income sheet, to indicate its content more definitely, presents the volume of sales and other revenue, the operating charges, and the operating balance, exhibits the effect of ancillary and nonoperating charges and credits, indicates the assignment or distribution of net earnings to contractual and proprietary investors, and shows the disposition of undistributed profits for the period together with the adjustments of accumulated surplus or deficit."

and,

"there appears to be some increase in the number of corporations that follow the commendable practice of presenting income and related surplus data in combined form. It remains standard procedure, however, to show surplus debits and credits in one or more separate statements of schedules. This is not seriously objectionable where the surplus data follow directly after the income statement and there is a clear indication of the connection".

Earning Power Concept

The advocates of the "earning power" approach believe that the profit and loss statement should emphasize the probable regular earning power of the business which results from ordinary business operations. It is their belief that no extraordinary or non-recurring items or adjustments applicable to prior periods should be included in the determination of the profit or loss from operations for the year. Much of the demand for the statement based upon the "earning power" concept comes from those persons primarily interested in predicting the future earnings of the business for the purposes of determining the market value of the shares. Because they do not realize that the periodic statements of profit and loss are in reality "interim" statements, and as such prepared in accordance with certain accounting conventions, the often quoted figure "earnings per share" can be at times very misleading.

Most authors of accounting texts adhere to the "earning power" concept. To what extent this adherence is based upon the assumption that all items relating to previous years' operations or activities should be regarded as being outside the orbit of the current operations and should be cleared through surplus, or in other words through the capital as at the beginning of the period under review, would be difficult to determine.

In his text "Advanced Accounting", Roy B. Kester advocates the carrying of adjustments in respect of prior periods and extraordinary items directly to surplus and sets out one of the main objections to the statement prepared using the "historical" approach, as will be seen by the following excerpts:

"The operation of a business results in a continuous flow of income activities day after day and period after period. To provide suitable control to management and to furnish periodic reports to owners and others, it becomes necessary to break the flow of such activities at regular intervals for the purpose of a formal accounting. It is customary to draft two reports on profits, the one being limited to the profit activities of the current period, the other to the changes in the accumulated profits of prior periods invested in the business. The dividing line between the two is usually difficult to draw. In theory the one, the statement of income operations, has as its basic purpose a measurement of the net profits earned during the current period. A series of such statements, period after period, thus becomes a rough indication of the normal earning power of the business, and a constantly corrected cumulative statement is a quite satisfactory index of earning power. In theory the other, the statement of earned surplus, is a report on the portions of profits left for investment in the business, including those of both prior and current periods. As such it should report on the adjustment of prior period's profits, brought about by better factual knowledge than was available at the time the profits of each prior period were reported. Such an adjustment belongs to the report of earned surplus for in that repository is the only place where such profits—i.e., the residuum of them—can be reached and to report them as belonging to the current period's report is to misallocate and misdate them. Included also in the statement of earned surplus is a report of those extraordinary losses and gains which from their nature belong to no single period of the corporation's life; they are casualties and windfalls whose incidence is largely in the lap of chance and can seldom, if ever, be controlled. Included also is a report on the dispositions made of the profits turned over to it."

"Only such losses as occur more or less regularly, and within the experience of the business can be fairly estimated, are proper charges to the current period. It is not the *normal* function of the periodic statement of income operations to reflect charges covering abnormal costs and losses which are beyond the control of the management. These must find record and reflection elsewhere."

"There is considerable use and advocacy of the combined statement of income operations and earned surplus . . ."

"The serious objection to this form of statement is its failure to emphasize the item 'Net Profit for the period'; it has become merely a 'way station' between Net Sales and Earned Surplus at the end of the period; and the relationship between current periods 'Net Sales', the opening item of the statement, and the closing amount of Earned Surplus, the final item, is not significant. The combined statement loses emphasis on a good many of the significant relationships."

Hatfield, Sanders and Burton in their text "Accounting Principles and Practices" have the following to say in respect of adjustments in respect of prior years:

> "It is inevitable that mistakes will be made in the calculation and statement of current profits. The amount by which the plant was depreciated in preceding years may have been underestimated, resulting in a corresponding exaggeration of profits in those years.
>
> "There is some difference of opinion among accountants as to whether the correction should be made through the income of the year when the error is discovered, or through the Surplus account ...... The other view, which is here held to be correct, is that the charge should be made to Earned Surplus . . . To make the correction through the current Income account would, for the time, leave unaltered the incorrect statement of the profits accumulated in previous years and would introduce the additional error of wrongly stating the profits of the current year."

Fair and Reasonable Disclosure

Both schools of thought agree upon the necessity for complete and intelligent disclosure of all material extraordinary items, but the supporters of the "earning power" concept claim that there is less danger of a misleading inference being drawn if such items are excluded from the figure "net profit for the year on operations" and further, that the items are brought to the readers' attention more forcibly if they are recorded as special adjustments to surplus. In addition they claim that the inclusion of such items tends to minimize the importance of the item "net profit for the year", which is the real purpose for which the statement is prepared.

Certainly the aim of both schools of thought is to provide statements which present information in a more readily understandable form for those persons most likely to act upon it. Unfortunately the average person, not trained in the art of reading and interpreting accounting statements, has little or no appreciation of the principles and, by force of necessity, the accounting conventions, upon which such statements are prepared. Also he usually believes that the statements are prepared to present the information in which he is particularly interested, little realizing that most published statements are what might be termed "general purpose" statements. These misconceptions on the part of the public at large impose a heavy burden of responsibility on the accountant, whatever his school of thought, to ensure that a fair and reasonable picture is presented.

An Introduction to Corporate Accounting Standards by W. A. Paton and A. C. Littleton sets out the case for complete income reporting as follows:

"The importance to all interests of a knowledge of a given corporation's periodic net income and level of sustained earning power can hardly be exaggerated. It need not be surprising, then, that business men and public accountants have been placing an increasing emphasis on the income statement in recent years—that the income report has supplanted the balance sheet as a focus of attention. It is noticeable, moreover, that whereas the balance sheet was formerly regarded primarily as a statement of financial condition for credit purposes the present tendency is to view this statement as vitally linked to the processes of periodic income measurement.

"The issue may be stated in this way. On one side is the feeling that restricting the income statement to reporting recurring costs and revenues drives other factors affecting earnings—often of marked importance—into the obscurity of surplus adjustments. On the other side is the opinion that an analysis of surplus, presented with the income statement and balance sheet, is revealing rather than obscuring, and that bringing the 'adjustments' into the income statement would tend to cloud the picture of recurring earning power.

"Those who advocate the use of a separate surplus analysis for the purpose of reporting non-recurring items seem to be convinced that this device is a satisfactory means of meeting the modern demand of an emphasis on sustained earning power without undue minimizing of irregular charges and credits. To this group, combined reporting of recurring and non-recurring elements in a single statement seems to partake of adherence to an outmoded concept of income computation as an indiscriminate assembling of any and all changes in the proprietary or residual equity.

"The advocates of combined reporting, however, do not rest their case upon adherence to tradition. They feel that there is something fundamental to accounting involved, namely, the effective reporting of the results of management's administration of the assets placed in its charge. A wide separation of the two kinds of results tends to focus the reader's attention unduly upon recurring earnings and thus lessen his conscious consideration of the over-all effectiveness of management. For example, if current recurrent earnings reported in the income statement are satisfactory, the reader may miss completely the significance of a large write-off of long-accruing obsolescence against present surplus. He may not see the question: Were past statements of income reported as correctly as could have been expected from a discerning management? In this connection it must be evident that the perspective to be gained from an examination of a series of past income statements which are complete in their presentation of material facts may be very useful.

"A definite position is taken here to the effect that all determinants of income in the broadest sense—including unusual and irregular factors—should be reported in the income statement before the net results are passed to the stock equity section of the balance sheet."

The results of the immediately previous year, or in fact of all previous years, are in reality no sure indication of the future prospects of a concern. The many factors which go to make up the economic structure of the world in which we live are complex and interrelated and not only do they vary from day to day, but the relationship between them is always changing. Few people today base their judgment of things to come entirely on the happenings of the last eight years, or on the last sixteen years. Past events may be indicators, but they are not gauges.

The independent accountant should keep in mind that there may be factors of which he is more or less aware which come into play to influence the determination of the figure for net profit, so that it will be shown as artificially high, low, or stable. In times of prosperous economy, as well as in times of relatively high tax rates, there will often be a tendency to keep the figure for net profit down. In times of depression the tendency will be to show a more favorable picture than would ordinarily be determined. In all instances there is a tendency to level off the fluctuations of the business cycle.

An objection sometimes heard in connection with some financial statements, but not those prepared on the basis of the historical concept, is that there are charges which, in the ordinary course of events one would expect to be included in the statement of profit and loss, but for one reason or another do not appear on the profit and loss statements but are carried directly to surplus. For instance, in the case of depreciation which is now generally accepted as being a cost of carrying on business, the amount charged for any given year or years may be determined to be understated. According to the earning power concept, the amount of the adjustment should be, and often is, carried directly to surplus. Thus the profit and loss statements show only part of the total depreciation charged off during the life of the particular asset.

In times of prosperous conditions the "unusual" entries and other adjustments which are carried directly to surplus arouse little if any comment, however in periods of recession or depression, such transactions are the subject of critical scrutiny. Also, in such times there is more often occasion for correction of judgment, due to better hindsight

than foresight, and the number of unusual items which have to be carried through the surplus account usually increases. The early thirties saw many instances of profit and loss statements which showed "profits" at the same time the attached surplus accounts were subject to drastic reductions from many different causes. The most outstanding example to come to notice was that of the 1931 statement of a corporation, which showed a profit for the year of $770,000 while the surplus account dropped $49,500,000. While some $16,000,000 of this amount was to cover fixed asset revaluations, approximately $10,300,000 was in respect of the write down of inventory values. Instances such as the above were the basis for the following comment:

> *"They (surpluses) are not, however, a graveyard in which all the secrets of mismanagement may be buried."
>
> "Further, it must be insisted that the use of the word 'profit' is a trifle far-fetched in a statement which shows a precipitous decline in the well-being of the corporation, as revealed in the drop in its surplus."

Another factor which casts doubt upon the validity of carrying all unusual items and adjustments relating to prior years directly to surplus is the consistency with which the debits to surplus exceed the credits. If such profit and loss and surplus statements were recast on the historical basis, the net profit figures would be lower than those already shown. This only serves to emphasize the ever present tendency to explain many of the items which would have an unfavorable effect on the net profit figure as being unusual or related to prior years, with the aforementioned result.

In any consideration of the merits of these two concepts, it should be kept in mind that the operations for the year cannot be regarded as standing as an isolated unit, but are related to a greater or lesser degree to all previous operations of the business, and also, while a transaction may be thought to be extraordinary or non-recurring it may be so closely related to current operations that the profit and loss statement for the year may be the only proper place to show its effect.

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*From—Give the Stockholder the Truth, by Anderson F. Farr in Scribners—April 1933.

Obituary

The Late Charles Arthur Paterson

The Institute of Chartered Accountants of Quebec announces with deep regret the death of Charles Arthur Paterson, after a lengthy illness, in his sixty-fifth year.

Born in Buckshorn, Aberdeenshire, Scotland, Mr. Paterson came to Canada in 1904 and joined the staff of the Bank of Toronto in Montreal. In 1905 he entered the employ of Macintosh and Hyde, Chartered Accountants and in 1909 passed the final examination of the Quebec Institute. For a number of years he was a partner in the firm of Macintosh, Robertson & Paterson. He is survived by a brother, John Paterson, a member of the Institute, and two sisters resident in Dundee, Scotland.

Mr. Paterson was highly regarded in the profession and served both on the Examining Board and the Council of the Institute from 1924 to 1926. He will be greatly missed by his confreres.

To his family the members of the Institute extend sincere sympathy.

Income Tax Directive Number 53

Issued by the Deputy Minister (Taxation)

Department of National Revenue

July 9, 1947.

ADMINISTRATION—INTERIM OR TENTATIVE RETURNS OF INCOME

From time to time, taxpayers have offered tentative or interim returns, from which a statement of income has been omitted or is given in round figures and described as "preliminary" or "estimated". Sometimes, the figures are given without such a qualification but are not supported by the relative accounts, vouchers or other prescribed or necessary data. Such returns cannot be accepted as fulfilling the requirements of the Act and those who file them expose themselves to the full penalties for late filing or failure to file.

There should be no circumstances under which a corporation can be excused for late filing, bearing in mind that the Act gives it six months from the end of its relative fiscal year in which to file. Therefore, we shall require definitive returns, in complete form, within the required period. We shall also require definitive returns, by the prescribed date, from persons engaged in a business or profession and able to employ a bookkeeper or an accountant.

As to persons other than those referred to in the previous paragraph, it may happen occasionally that a sudden illness just before the filing date may make it impossible for a taxpayer to put in a definitive and final return on time. Even in those circumstances, of course, he is open to the penalties provided for by the law if he files no return by 30th April. However, in these or other exceptional and rare circumstances, the disposition will be to accept a tentative return from a private individual if the following conditions are observed:

1. The tentative return must be made on the prescribed Form (T-1 General or T.1 Special) and must be filed by the due date, together with a letter from the taxpayer or his agent or attorney, explaining why a complete return cannot be provided. (A letter by itself is in no sense a compliance with the law and cannot be accepted even as a tentative return).
2. The return must be filled in to the fullest extent possible. The taxpayer, or, if the latter is unable to attend to the matter himself, his agent or attorney, must estimate the income as closely as possible, using the last previous year's income figures where no other data is available.
3. If the tax deducted at the source or paid by the taxpayer's own hand prior to the date of filing the tentative return is not equal to the tax payable in respect of the estimated income, then a payment equal to the amount estimated to be due must accompany the tentative return.
4. The definitive return must be filed within two months from the date prescribed for the filing of returns of income.

If, after the definitive return is filed, the income is found on audit to be one-third or more in excess of the estimated income shown in the tentative return, the full penalty for late filing will be imposed.

The above statement is to be taken as a guide for general use but this Office will reserve the right to review any case in which it appears that an effort is being made to secure an advantage not warranted by the circumstances. By this time, all citizens should know very well what the law calls on them to do in respect of the filing of an income tax return by 30th April and they should be getting together all the necessary vouchers and information in the four preceding months. Only in circumstances of distinctly exceptional character should a tentative return be necessary.

Personals

C. W. Nicholl & Co., Chartered Accountants, 737 Fort Street, Victoria, announce the removal of their office to 618-619 Central Building, 620 View Street, Victoria, B.C., having succeeded to the practice of James Price & Co., Chartered Accountants.

Howard, Munn & Richards, Chartered Accountants, announce the removal of their offices to Fourth floor, Toronto General Trusts Building, Calgary, Alberta.

Metherell & Jackson, Chartered Accountants, Hamilton, Ontario, announce the opening of a branch office at 52 Albert Street, Stratford, Ontario, under the management of Philip C. Metherell, Chartered Accountant.

Messrs. Winspear, Hamilton, Anderson and Company, Chartered Accountants, announce the removal of their Calgary office to Fourth floor, Toronto General Trusts Building, 315-8th Avenue West, Calgary, Alberta. H. H. Love, B. Com., C.A., is the Resident Partner.

R. P. Egerton, C.A., announces the opening of an office at 193 Sparks Street, Ottawa, Ontario.

Current Accounting Literature

By Frank S. Capon, C.A.
Montreal, P.Q.

Budgetary Control

ONCE AGAIN the N.A.C.A. has published an outstanding article on some phase of budgeting, the 15th June Bulletin containing a paper by C. H. Eckelkamp on an approach to budgetary control. Dealing with a specific case, the writer outlines the studies of historical data made before the budgetary system was installed, and in particular he outlines the system of scatter charts which produce a trend for any particular expense at varying levels of operations, based on past experience. This device shows the fixed portion of each expense and also the variable amount at each level of operation and quickly indicates any point which is out of line with the trend and which requires investigation. The system outlined predetermines attainable financial results from operations and the financial position at the end of a given period and also provides a basis for measuring financial performance currently against the predetermined pattern.

Custom-built Tax Manuals

H. C. Weber has presented a very interesting paper in the same Bulletin, suggesting the preparation of personalized tax manuals for companies which are required to comply with a variety of tax laws. The system calls for extracting the essential data concerning each tax or each return, preparing a looseleaf sheet summarizing this data, and filing the sheets in chronological order according to return dates. These sheets would of course be kept up to date for all amendments to the tax acts and should be reviewed briefly before the relative returns are prepared.

PUBLICATION ADDRESSES, AND PRICE PER COPY POSTPAID

Accountancy, Incorporated Accountants' Hall, Victoria Embankment, London, W.C. 2, England. 1 shilling.
Accountants' Magazine, 23 Rutland Square, Edinburgh, Scotland. 1s. 3d.
Accounting Review, School of Commerce, Northwestern University, Evanston, Ill., U.S.A. $1.
The Accountant, 42 Baker St., London W. 1., England. 1 shilling.
The Controller, 1 East 42nd St., New York, N.Y. 50 cents.
Cost and Management, 66 King St. East, Hamilton, Ont. 35 cents.
Harvard Business Review, Harvard University, Boston, Mass., U.S.A. $1.50.
Journal of Accountancy, 13 East 41st St., New York, N.Y. 35 cents.
The Internal Auditor, 39 Atlantic Street, Stamford, Conn., U.S.A. $1.
National Association of Cost Accountants, 385 Madison Ave., New York. 75 cents.
Taxes—The Tax Magazine. CCH Canadian Limited, 31 Willcocks St., Toronto, Ont. $6.00 per year. (American Publication).

Education for Management

In its editorial of 31st May, "The Accountant" produces some data on education for management. The old system of promoting to management jobs from the pool of long-service personnel is being supplanted to some extent by appointments from the technically trained graduates with shorter business experience, but the British training system is producing technical graduates at less than 1/10 of the comparable U.S. rate. In view of the constant loss of such Canadian trainees to the U.S., it may be necessary to review our training of accountants to see if requirements are being met.

Cost Accounting Developments

The second part of the article on development of cost and financial accounting techniques appears in the 31st May issue of "The Accountant". Of particular importance is the author's denunciation of those who hold to established procedures in the face of new techniques which are obvious improvements and he calls for intensive research by the accounting institutes in order to speed up progress.

Fantasy Again

If public officials have any humour left, they should appreciate "Alice in profits tax land", published in the 14th June copy of "The Accountant". This delightful and subtle method of pointing out the absurd complexity of modern tax legislation should cause even the most jaded tax specialist to chuckle and admit that it is time to pull down the house of cards and start again. Fortunately this process is now under way with regard to our main tax act, but this type of satire might well produce results in other fields.

Indirect or Fixed Charges in Costs

Two English authors have published a book claiming that costs should exclude all fixed charges, and Professor W. T. Baxter of the London School of Economics has presented some pros and cons in the 21st June issue of "The Accountant". There is much to be said for the inclusion of direct costs only, but there are also serious disadvantages, so that it is impossible to be dogmatic. The special requirements of each case must apparently dictate the type of cost figures to be prepared.

Independence of the Public Accountant

The July issue of "The Journal of Accountancy" contains a draft statement by the Council of the American Institute on the independence of the public accountants called upon to certify financial statements, and comments are requested for consideration before the statement is adopted as official policy of the Institute. Although Canadian laws make demands on accountants that are made only by custom in the U.S., this statement is equally applicable in Canada and is, therefore, worthy of study and constructive criticism by Canadian accountants.

Language of Financial Reports

Claiming that financial reports can be written so that 85% of the public can understand them, J. M. Lambie, writing in the July "Journal of Accountancy" gives many examples of the type of writing so often adopted by accountants which is so confusing to the layman. The author points out that accountants are much more than bookkeepers, that they are in fact reporters, and they fail in their task if their reports do not communicate to the average reader the facts that he should know.

Consolidated Statements

"What to eliminate in the preparation of consolidated balance sheets" is the explanatory title of a brief article by G. J. Nowak in the July "Journal of Accountancy". Asset valuations, profit on inventories and capital, premiums, investment in subsidiaries, and other items are covered and the suggested treatments are evidence of the constant, if gradual, changes in accounting principles.

The Role of the Accountant in Labour Management

Three important articles dealing with accountants and labour relations appear in the July "Journal of Accountancy". F. E. King, an industrialist, gives management's views of the need of accounting information for labour conferences and the need for facts developed by accountants. M. H. Hedges of the AFL stresses for labour that objectivity is the great need in labour controversies and that the impartial accountant is the man who can produce the facts. Thirdly, a professional accountant, M. H. Stans, tells accountants how to make labour negotiations speedier, more fair and less destructive by furnishing facts on which objective decisions can be based.

Duties of Internal Auditor

Three main phases of the internal auditor's functions are the responsibility to safeguard money and property, the responsibility to train staff for other management functions, and the responsibility of carrying out special assignments, according to a recent report by the Controllers Institute Committee on Technical Information and Research. These duties are outlined in the July issue of "The Controller" and many ancilliary duties allotted in specific companies are also summarized from replies to a questionnaire sent out by the Institute.

An important, and fairly detailed, article on the duties of the internal auditor has been contributed by Arthur H. Kent in the same magazine. The author shows the extent to which detailed auditing previously allotted to public accountants is being undertaken by internal auditors, and also deals with the extent to which the internal auditor must ensure that policies and procedures established by management are being carried out. He also covers the phases of staff selection, training, attitudes and relationships.

Control of Records and Forms

During the war almost every industry found itself snowed under with multitudes of forms and many of these seem to have become almost permanent. This problem is pointed up in a brief article by F. S. Slick in the July issue of "The Controller", which includes a recommendation for the appointment of an internal committee in each company to review all forms and approve new forms and also to control the maintenance and destruction of records. An excellent check list is given for use in reviewing forms or deciding whether a new form is really necessary.

How are Your Verbs?

By George L. McCalla

THOSE who write on auditing make surprisingly heavy use of a few verbs according to a recent study of 1,720 pages of auditing literature.*

Four hundred and seventy-five different verbs appeared and were used a total of 6,500 times but 14 of the verbs were used 2,700 times, and the top 5 accounted for 1,400 uses. In summary:

Each verb used	Number of verbs		Times used	
Over 200 times	5	1%	1,400	20%
101 - 200	9	2	1,300	20
20 - 100	61	12	2,300	37
Less than 20	400	85	1,500	23
	475	100%	6,500	100%

This may ease your mind when next you write a report and are troubled by your repeated use of a few words; perhaps there are no good substitutes to vary your text. Possibly you can say to yourself that public accountants have attained maturity and agreed upon precise definitions for a number of verbs.

(Or perhaps they have stagnated and cannot reach out beyond the banal and hackneyed beaten track.)

The verbs used over 200 times:

Examine	532
Verify	249
Determine	229
Ascertain	208
Test	206
	1,424

(Look at that word "examine"!)
(What does verify mean?)
Used 101 to 200 times:

Review	178
Check	173
Compare	172

Investigate	142
Consider	138
Obtain	137
Inquire	121
Inspect	105
Prepare	103
	1,269

Mr. Littleton's article also shows the other 61 verbs used 20 times or more.

Does not your familiarity with all of these words make you want to jolt the old grey matter when writing your next report and hold your use of these words to an irreducible minimum Won't your clients prefer a little freshness and imagination to stereotyped rehash?

Apropos of words, the following appeared in THE CANADIAN CHARTERED ACCOUNTANT recently:

"We know a professor in Toronto who hinted in class (to no avail, he says) that bonds may in their lifetime have a spiritual experience because they are capable both of redemption and conversion. We take it that his assertion would apply equally to all bonds regardless of their denomination, though no doubt only the more mature ones would be interested."

* By A. C. Littleton of the University of Illinois in the *Accounting Review* of January 1947, page 80.

Reprinted from The Spokesman, The official organ of the Pennsylvania Institute of Certified Public Accountants.

BALANCED ACCOUNTS

The following sentences appeared in a review of Edwin O. Reischauer's "Japan, Past and Present" in the Saturday Review of Literature, April 5, 1947.

> "Jean Reischauer's maps are a considerable asset. On the debit side must be mentioned the lack of bibliography."

We were assured years ago when we became chartered accountants that this business of debits and credits was easy. Now we are all mixed up again. What journal entry is required to correct this error in posting?

STUDENTS' DEPARTMENT

J. E. Smyth, C.A., Editor

NOTES AND COMMENT

While reading the comments of our Research Director on current practice with respect to reserves some time ago (in the July issue of THE CANADIAN CHARTERED ACCOUNTANT), we began to meditate upon the inconvenience of changing one's ideas—even (or perhaps, especially) for the better.

As a matter of fact, we wouldn't dispute for a moment the view that (say) "Estimated liability for taxes" is incomparably more meaningful on a balance sheet than "Reserve for taxes". The trouble is, we have always called it Reserve for taxes; we learned it that way.

Yet we are at least going to take credit for misgivings about our resistance to change. It is only too true that when past education becomes a bulwark *against* future education, it has ceased to be any education at all.

Please do not think us accustomed to calling inanimate objects names (except of course when we stumble over them) but there is a nice, soft easy chair in our living room at home that seems to us to beg the name "Status Quo". One just can't sit in that chair and think of ways to reform and to improve—it's too comfortable. And there never seems to be any incentive to move to other chairs in the room (for all that might help one's posture) because they are all harder.

We certainly admire those accountants whom it is our good fortune to know who can entertain new ideas with a grace which reflects the true measure of their education; whose first reaction to a proposed change is not a thin reason or a slim excuse to justify those techniques with which they are already familiar; who will put what they believe to be an improvement ahead of the inconvenience it causes, any day. Our guess is that the accounting profession is blessed with a good proportion of such persons. Most students can probably think of a senior whom they admire for these reasons. These accountants guarantee the future of their profession.

We recall an audit in which the bookkeeping left something to be desired (which description, it is submitted, will

leave the audit unidentified). The senior auditor had prepared some years before a list of proposed improvements. It became an audit routine each year to put some twenty-odd questions to the bookkeeper to ascertain which (if any) of the improvements had been instituted. On one occasion your editor questioned him and received, as usual, a consistent series of "no's". Finally, perhaps a little in exasperation, the bookkeeper turned and said, "Oh, we never make any changes around here. Things are complicated enough as they are!"

PROBLEMS AND SOLUTIONS

THE PROVINCIAL INSTITUTE OF CHARTERED ACCOUNTANTS

Solutions presented in this section are prepared by practising members of the several provincial Institutes and represent the personal views and opinions of those members. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM I

Intermediate examination, December 1946

Accounting II, Question 3 (20 marks)

Comparative balance sheets of the Provincial Manufacturers Limited are as follows:

	As at 31st October 1945	As at 31st October 1946
Cash	$ 53,600	$ 126,400
Victory bonds	202,500	
Accounts receivable	473,000	708,300
Inventory	580,900	665,600
Prepaid expenses	10,200	7,000
Investments in subsidiaries	344,500	314,000
Fixed assets at cost	685,000	726,800
	$2,349,700	$2,548,100
Accounts payable	$ 375,900	$ 427,200
Reserve for income taxes	57,000	74,100
Reserve for depreciation	268,000	283,000
Capital stock	1,000,000	1,150,000
Earned surplus	648,800	613,800
	$2,349,700	$2,548,100

The loss of $1,000 on the sale of a fixed asset during the year, which cost $10,000 and had an accumulated applicable reserve for depreciation of $5,000, was charged to profit and loss. The profits of $4,500 on sale of shares in a subsidiary (book value $30,500) and $5,000 on sale of Victory bonds had been credited to profit and loss. Profits for the year ended 31st October 1946 after provision for depreciation amounted to $115,000. Dividends paid during the same period amounted to $150,000 of which $75,000 was a stock dividend and $75,000 paid in cash.

Required:

A statement of application of funds and changes in working capital for the year ended 31st October 1946.

SOLUTION

PROVINCIAL MANUFACTURERS LIMITED
STATEMENT OF SOURCE AND DISPOSITION OF FUNDS
For the year ended October 31, 1946.

Source of funds:		
Net profit from operations (see note below)		$111,500
Add non cash charges to income:		
Depreciation provided		20,000
Total funds available from operations		131,500
Proceeds from sale of		
Shares in subsidiary ($30,500 plus $4,500)		35,000
Fixed asset		4,000
Proceeds from issue of further capital stock		75,000
Funds made available during year		245,500
Disposition of funds:		
For acquisition of fixed assets ($41,800 plus $10,000)	$51,800	
By payment of cash dividend	75,000	
		126,800
Increase in working capital during year		$118,700

NOTE:

Calculation of operating profit for year:	
Profit after depreciation, etc. as stated	$115,000
Add: Loss on disposal fixed asset	1,000
	116,000
Deduct: gain on sale of shares in subsidiary	4,500
	$111,500

PROVINCIAL MANUFACTURERS LIMITED
STATEMENT OF CHANGES IN WORKING CAPITAL
Year ended October 31, 1946.

	Oct. 31 1945	Oct. 31 1946	Working Capital Increase	Working Capital Decrease
Cash	53,600	126,400	72,800	
Victory Bonds	202,500			202,500
Accounts Receivable	473,000	708,300	235,300	
Inventory	580,900	665,600	84,700	
Prepaid Expenses	10,200	7,000		3,200
	1,320,200	1,507,300		
Accounts Payable	375,900	427,200		51,300
Reserve for Income Taxes	57,000	74,100		17,100
	432,900	501,300		
Increase in Working Capital				118,700
Working Capital	$ 887,300	$1,006,000	$392,800	$392,800

PROBLEM II

Final examination, December 1946

Accounting III, Question 1 (35 marks)

X Coy. was incorporated on 1st January 1938 with a capitalization of $4,000,000 being 40,000 common shares of $100 each. It purchased on 1st January 1945 a 90% interest in Y Coy. and on 1st April 1945 an 80% interest in Z Coy.

The following are the trial balances as at 31st December 1945:

(1) Debits	X Coy.	Y Coy.	Z Coy.
Cash	$ 175,000	$ 405,000	$ 120,000
Accounts receivable	1,500,000	800,000	500,000
Notes receivable	120,000	75,000	35,000
Inventories, 1st January			
Raw materials	1,000,000	600,000	1,000,000
Goods in process	500,000	300,000	400,000
Finished goods	1,300,000	100,000	800,000
Machinery and equipment (net)	1,500,000	1,000,000	500,000
Buildings (net)	400,000	500,000	200,000
Bonds of Z Coy.	200,000	50,000	......
Bonds of Y. Coy.	300,000	......	......
Treasury bonds	200,000	......	......
Investment in stock of Y Mfg. Coy. at cost	3,000,000	......	......
Investment in stock of Z Coy. at cost	1,800,000	......	......
Goodwill	200,000	100,000	50,000
Organization expense	50,000	......	......
Prepaid expense	300,000	100,000	75,000
Sinking fund trustee	140,000	50,000	100,000
Y Coy. current	300,000	......	......
Z Coy. current	200,000	......	......
Wages	694,000	298,600	301,500
Manufacturing overhead including depreciation	530,000	278,000	275,000
Selling expense	992,000	373,000	250,000
Administrative expense	1,800,000	580,000	400,000
Bond interest	72,000	30,000	12,500
Sundry expenses	100,000	10,000	60,000
Sales discounts	40,000	15,000	12,000
Sales allowances	60,000	14,000	......
Purchases, raw material	2,546,000	1,017,000	725,000
Advance payments 1945 income and excess profits taxes	120,000	150,000	100,000
	$20,139,000	$6,845,600	$5,916,000

(2) Credits	X Coy.	Y Coy.	Z Coy.
Accrued bond interest	$ 36,000	$ 15,000	......
Accounts payable	986,000	400,000	$ 300,000
Notes payable	100,000	50,000	60,000
Notes rec. discounted	60,000	......	10,000
Bonds payable	2,000,000	500,000	500,000
Sinking fund reserve	150,000	50,000	100,000
X Coy. current	......	300,000	200,000
Reserve for bad debts	75,000	35,000	25,000
Interest income	35,000	6,000	7,000
Sales	8,000,000	2,800,000	3,000,000
Premium on bonds	20,000	......	......

Capital stock	4,000,000	2,000,000	1,000,000
Surplus	4,677,000	689,600	714,000
	$20,139,000	$6,845,600	$5,916,000

You obtain the following additional information:

Bonds Payable

	Dated		Interest	Period	Sinking Fund Requirement
X Coy.	1st Jan. 1942	4%	Jan.-July	40 years	$50,000 annually
Y Coy.	1st Jan. 1943	6%	Jan.-July	20 years	25,000 annually
Z Coy.	1st Mar. 1941	5%	Mar.-Sept.	20 years	25,000 annually

Inventories 31st December 1945

	Raw Material	Goods in Process	Finished Goods
X Coy.	$800,000	$600,000	$1,000,000
Y Coy.	700,000	400,000	400,000
Z Coy.	700,000	600,000	400,000

Inter-company profits in inventories, 31st December 1945

In X inventory purchased from Y	$85,000
In Y inventory purchased from X	50,000
In Z inventory purchased from X	45,000

In the inventories of the X Coy. on 1st January 1945 were goods purchased from the Y Manufacturing Coy. and on which the latter had made a profit of $42,000.

Inter-Company bond purchases were made 1st January 1944 at par.

Notes Receivable—Of the X Coy. contains a $50,000 note of the Z Coy. This note has been discounted. Of the Z Coy. contains a $25,000 note received from the Y Manufacturing Coy.

Companies file separate income tax returns. Tax rate 40%.

REQUIRED:

Prepare:

Statement of eliminations upon consolidation, and any adjustments you consider necessary.

Statements as at 31st December 1945, of

(a) Consolidated goodwill.

(b) Minority interest.

(c) Consolidated surplus.

All calculations to nearest dollar.

SOLUTION

Eliminations

1. Z's notes receivable in X books also payable in Z books	$ 50,000
2. Y's notes receivable in Z books also payable in Y books	25,000
3. Z bonds in X books and liability in Z books	200,000
4. Z bonds in Y books and liability in Z books	50,000
5. Y bonds in X books and liability in Y books	300,000
6. Y stock in X books	3,000,000
7. Z stock in X books	1,800,000
8. Y current account in X books also X current account in Y books	300,000
9. Z current account in X books also X current account in Z books	200,000
10. Y bond interest received by X and also from Y bond interest expense	18,000
11. Z bond interest received by X and also from Z bond interest expense	10,000

12. Z bond interest received by Y and also from Z bond interest expense			2,500
13. Profit in X inventory (90% of $85,000)			76,500
14. Profit in Y inventory			50,000
15. Profit in Z inventory			45,000
16. X accrued interest receivable			
On Y bonds (6% on $300,000 for six months)		$ 9,000	
On Z bonds (5% on $200,000 for ten months)		8,333	
		17,333	
Y accrued interest receivable			
OnZ bonds (5% on $50,000 for ten months)		2,083	
			19,416
17. Y bond interest accrued			
On bonds held by X		9,000	
Z bond interest accrued and payable			
On bonds held by X	$8,333		
On bonds held by Y	2,083		
		10,416	
			19,416
18. Notes receivable discounted to be shown as liability to the bank		50,000	
Notes receivable discounted to be deducted from notes receivable		20,000	
			70,000

Adjustments

	Dr.	Cr.
1. Adjust all inventories to values at December 31, 1945		
2. X profit and loss	5,000	
X surplus	15,000	
X organization expense		20,000
Writing off organization expense for four years (Actual amount not important, only principle involved).		
3. Z surplus	8,333	
Z bond interest expense	12,500	
Z bond interest payable		12,500
Z bond interest accrued		8,333
To adjust profits of previous year in which interest was not accrued, to record interest overdue since September 1, 1945, and to accrue bond interest September 1—December 31, 1945.		
4. X accrued interest receivable	8,333	
Y accrued interest receivable	2,083	
X interest income		8,333
Y interest income		2,083
Being interest accrued to December 31, 1945 on Z bonds.		
5. X accrued interest receivable	9,000	
X interest income		9,000
Being interest accrued to December 31, 1945 on Y bonds.		
6. X premium on bonds	2,000	
X surplus		1,500
X bond interest expense		500

Writing off bond premium for four years on basis of forty years (Acceptable if one year written off, $500).		
7. X profit and loss	327,333	
Y profit and loss	276,993	
Z profit and loss	183,400	
X provision for income and excess profits taxes		327,333
Y provision for income and excess profits taxes		276,993
Z provision for income and excess profits taxes		183,400
Being provision at 40% on profit for year, per working papers attached.		
X provision for income and excess profits taxes	120,000	
Y provision for income and excess profits taxes	150,000	
Z provision for income and excess profits taxes	100,000	
X advance payments		120,000
Y advance payments		150,000
Z advance payments		100,000
To adjust tax liability by amount of advance payments.		

(Continued on page 170)

DISCUSSION OF PROBLEM SOLUTION JULY ISSUE, 1947

Toronto, Ontario, July 23, 1947.

Dear Sir,

In regard to Problem I on page 54 of the July issue of The Canadian Chartered Accountant, I should like to make the following comments in regard to the solution which you give. It is quite possible to go along with #'s 2 and 3 and also paragraph (b) of the answer, but I think a certain amount of reservation is in order in regard to the first item in this answer.

If a perpetual inventory is used as the basis of either cost of inventory pricing at the end of a period, or both, then considerable care should be taken. In illustration I am giving below two examples (very elementary I admit) of just what can happen in regard to such averages:—

"A"

Buy	1,000	units @	$1.00—	$1,000.00	
Buy	800	units @	.75	600.00	
Total	1,800	units		1,600.00	(88.9c average)
Charge to operations	600	units @	.889	533.40	
On hand	1,200	units		$1,066.60	(88.9c average)

"B"

Buy	1,000	units @	$1.00	$1,000.00	
Charge to operations	600	units @	1.00	600.00	
	400	units		400.00	
Buy	800	units @	.75	600.00	
On hand	1,200	units		$1,000.00	(83.3c average)

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WORKING PAPERS

STATEMENTS OF COST OF GOODS MANUFACTURED (NOT CONSOLIDATED)
for the year ended December 31, 1945

	X Coy.		Y Coy.		Z Coy.	
Inventory of work in process, January 1, 1945		$ 500,000		$ 300,000		$ 400,000
Wages		694,000		298,600		301,500
Cost of raw materials used:						
Inventory of raw materials, Jan. 1/45	$1,000,000		$ 600,000		$1,000,000	
Purchases	2,546,000		1,017,000		725,000	
	3,546,000		1,617,000		1,725,000	
Inventory of raw materials Dec. 31/45	800,000		700,000		700,000	
		2,746,000		917,000		1,025,000
Manufacturing overhead		530,000		278,000		275,000
		4,470,000		1,793,600		2,001.500
Deduct Inventory of work in process, December 31, 1945 ..		600,000		400,000		600,000
Cost of goods manufactured		3,870,000		1,393,600		1,401,500

WORKING PAPERS

Statements of Profit and Loss (Not Consolidated)
for the year ended December 31, 1945

	X Coy.		Y Coy.		Z Coy.	
Sales	$8,000,000		$2,800,000		$3,000,000	
Less allowances	60,000		14,000		—	
		$7,940,000		$2,786,000		$3,000,000
Deduct Cost of goods sold						
Inventory finished goods Jan. 1/45	1,300,000		100,000		800,000	
Cost of goods manufactured	3,870,000		1,393,600		1,401,500	
	5,170,000		1,493,600		2,201,500	
Inventory finished goods Dec. 31/45	1,000,000		400,000		400,000	
		4,170,000		1,093,600		1,801,500
Gross trading margin		3,770,000		1,692,400		1,198,500
Deduct						
Selling expenses	992,000		373,000		250,000	
Administrative expenses	1,800,000		580,000		400,000	
Sundry expenses	100,000		10,000		60,000	
		2,892,000		963,000		710,000
Net trading margin		878,000		729,400		488,500
Deduct Financial expenses (net)						
Bond interest expense (less $500 bond premium amortized, X Coy.)	71,500		30,000		25,000	
Discounts allowed	40,000		15,000		12,000	
Organization expense written off	5,000		—		—	
	116,500		45,000		37,000	
Less Interest income	52,333		8,083		7,000	
		64,167		36,917		30,000
Profit before taxes		813,833		692,483		458,500
Deduct Provision for taxes		327,333		276,993		183,400
Net profits		$ 486,500		$ 415,490		$ 275,100

(a) STATEMENT OF CALCULATION OF CONSOLIDATED GOODWILL AT DECEMBER 31, 1945

Cost of acquiring investment in Y Company, January 1, 1945		$3,000,000	
Shareholders' equity in Y Company, January 1, 1945			
Capital stock	$2,000,000		
Surplus	689,600		
Sinking fund reserve	50,000		
	2,739,600		
Interest acquired in equity of Y Company: 90%		2,465,640	
			$ 534,360
Cost of acquiring investment in Z Company, April 1, 1945		1,800,000	
Shareholders' equity in Z Company, April 1, 1945			
Capital stock	1,000,000		
Surplus, January 1, 1945, adjusted	705,666		
Profits, January 1—April 1, 1945	68,775		
Sinking fund reserve	100,000		
	1,874,441		
Interest acquired in equity of Z Company: 80%		1,499,553	
			300,447
Goodwill of X Company per trial balance			200,000
Goodwill of Y Company per trial balance			100,000
Goodwill of Z Company per trial balance			50,000
Total Goodwill			$1,184,807

(b) STATEMENT OF CALCULATION OF MINORITY INTEREST AT DECEMBER 31, 1945

	Y Company (10% interest)	Z Company (20% interest)
Capital stock	$ 200,000	$ 200,000
Surplus	68,960	141,133
Profits for 1945	41,549	55,020
Sinking fund reserve	5,000	20,000
	$ 315,509	$ 416,153

(c) STATEMENT OF CALCULATION OF CONSOLIDATED SURPLUS AT DECEMBER 31, 1945

Balance January 1, 1945				$4,677,000	
Adjustments re prior years:					
Deduct Organization expense written off				15,000	
				4,662,000	
Add Bond premium amortized				1,500	
Balance January 1, 1945, adjusted					$4,663,500
Add Profits for 1945	X Coy.	Y Coy.	Z Coy.	Total	
Profits per individual statements of profit and loss	$ 486,500	$ 415,490	$ 275,100	$1,177,090	
Less: Minority interest	—	41,549	55,020	96,569	
	486,500	373,941	220,080	1,080,521	
Less: Interest purchased in profits of Z Coy. at date of acquisition (April 1, 1945) per calculation of good-will—80% of $68,775			55,020	55,020	
	486,500	373,941	165,060	1,025,501	
Less: Inter-company profits in inventories	95,000	76,500	—	171,500	
	391,500	297,441	165,060		854,001
Balance December 31, 1945					$5,517,501

Editor's Notes:

(a) In calculating the provision for income and excess profits taxes of X Company, $5,000 charged as organization expense would not be allowed, and $500 bond premium amortized need not be included in taxable income. Accordingly provision for taxes is 40% of (813,833 + 5,000 — 500).

(b) In the trial balance of X Company as given in the problem the debit balance in "Sinking fund trustee" account is $140,000 while the credit balance in "Sinking fund reserve" is $150,000. This suggests that either an amount is owing to the trustee or the reserve is more than adequate, and the "adjustments" might then, according to the circumstances, also include one of the two following entries, respectively,

Dr. Sinking fund trustee	10,000	
Cr. Account payable to sinking fund trustee		10,000
or		
Dr. Sinking fund reserve	10,000	
Cr. Surplus		10,000

(c) The editor believes that there is a good argument for accruing the sinking fund instalments to December 31, 1945 since the working capital position at that date might otherwise be said to be overstated.

(d) The above solution is based upon the assumption that the figures given for inter-company profits in inventories are "net" after providing for 40% tax, since otherwise the elimination for inventories and surplus in the consolidating process should be 60% of $171,500 instead of $171,500.

(Continued from page 169)

Discussion of Problem Solution July Issue 1947.

It will be noticed that the same prices are used in both cases and the only difference is the different timing of the transactions. This may be the result of the mere order in which the transactions are entered on the stock cards. On the basis of "cost or market whichever is lower" would it not be better to take the inventory at the lowest figure shown for purchases in the period, without taking any account of averages?

Yours very truly,

A. I. Simmons.